



USAID | **ECUADOR**
FROM THE AMERICAN PEOPLE

THE PRODUCTIVE NETWORK PROJECT

CONSULTATIONS WITH THE U.S. FEDERAL DEPOSIT INSURANCE CORPORATION:

POLICY GUIDANCE TO STRENGTHEN ECUADOR'S BANK SUPERVISION, DEPOSIT INSURANCE, AND BANK RESOLUTION FRAMEWORK

October 23, 2007

This publication was produced for review by the United States Agency for International Development. It was prepared by the IRIS Center and CARANA Corporation.

I. Introduction

The Financial Services Volunteer Corps (FSVC) organized two days of consultations for a delegation of senior Ecuadorian officials at the United States Federal Deposit Insurance Corporation (FDIC) in Washington, D.C held on October 22-23, 2007. This program was organized in response to a request FSVC received from the CARANA Corporation, on behalf of the USAID mission in Ecuador. The goal the consultations was to provide expert policy guidance to senior Ecuadorian government officials on strengthening the existing bank¹ supervision, deposit insurance, and bank insolvency framework as they prepare a proposal to restructure the current legal framework in these areas for President Rafael Correa and Ecuador's Constituent Assembly in the coming weeks.

This report details the information presented by the FDIC and the discussions that ensued. This report seeks to present the highlights from the discussion, particularly the lessons learned from the U.S. experience.

II. Participants

The Ecuadorian delegation that participated in the Washington-based meetings with the FDIC was comprised of the following individuals: Mr. Rodrigo Espinosa: Deputy Superintendent of Banks, Superintendence of Banks; Mr. Victor Campoverde Encalasa, Advisor to the Board, Central Bank of Ecuador; Mr. Mauricio Martinez, Advisor to the Board, Central Bank of Ecuador; and Mr. Santiago Bayas, Vice President of Treasury, Banco Pichincha C.A.

From USAID, Bernai Velarde, Senior Financial Advisor, Ecuador; and William Baldrige, Senior Financial Markets Advisor, Bureau for Economic Growth, Agriculture and Trade, Washington, D.C., attended the meetings. Andres Ribadeneira, Policy Reform Manager, USAID Productive Network Project; Marcela Correa, Economist, CARANA Corporation; Santiago Sedaca, Director, USAID Productive Network Project; and Jessica Viner, Program Associate, FSVC also accompanied the delegation on this visit.

III. Overview of the FDIC

The unique structure of the U.S. regulatory, supervisory, and deposit insurance framework is deeply rooted in historical events and has evolved over many years, oftentimes as a response to a large systemic crisis.

The U.S. banking system today can be best characterized as large, diverse, and complex. There are 8,626 insured institutions, totaling \$12.3 trillion in assets, of which there are \$4.2 trillion insured deposits. The regulatory and supervisory responsibility for these 8,626 institutions is divided among the four federal agencies, the FDIC, the

¹ For the purposes of this paper and unless otherwise noted, the word "bank" used herein refers to all deposit taking commercial banks and thrift banks.

Federal Reserve, the Office of the Comptroller of the Currency (OCC), and the Office of Thrift Supervision (OTS), and shared with the fifty state supervisors. There is a high degree of coordination among these agencies, particularly to harmonize bank regulations, and bank supervision standards, policies, and procedures. To this end, all federal bank regulatory institutions belong to the Federal Financial Institutions Examination Council (FFIEC).

The FDIC has three principal functions: deposit insurance, bank supervision, and resolutions and receiverships. The balance of the deposit insurance fund for 2007 is \$51.2 billion and is funded through the interest earned on investments in U.S. Treasury obligations and deposit insurance assessments.

The FDIC is also the primary federal supervisor for 5,225 state-chartered, non-Federal Reserve-member institutions with \$2.2 trillion in assets. While the FDIC has primary regulatory and supervisory authority for state nonmember banks, as the deposit insurer the FDIC has backup regulatory authority for all insured deposit-taking institutions.

One important feature of the U.S. system is the independence of its regulatory and supervisory agencies. The FDIC is a **politically, financially, and operationally independent agency** of the U.S. government empowered to carry out its regulatory and supervisory duties without the approval of any other government institution or individual. However, the FDIC is held accountable by the U.S. Congress on financial and corporate governance issues. The FDIC is audited by the U.S. Government Accountability Office and its annual report is presented to Congress.

IV. Establishing an Effective Deposit Insurance and Bank Supervision System: A Discussion on Necessary Preconditions and Considerations

The lack of deposit insurance means that depositors are positioned to bear the loss in the event of a bank failure, which could potentially trigger bank runs caused by the rapid deterioration of the public's confidence in the banking system. This is precisely what led to the creation of the FDIC in the U.S. in 1933. The public had no way to discern which banks were financially sound from those that were not. The only way to restore the public's confidence was for the U.S. Government to introduce deposit insurance coverage.

V. Legal Preconditions

A strong legal system is the foundation of an effective deposit insurance scheme and bank supervision framework and is characterized as having five general preconditions:

- Government credibility;
- Fairness, efficiency, and accountability;

- Transparency;
- Enforceability; and
- Deterrence.

A deposit insurance scheme is only as strong as the regulatory and supervisory environment within which it operates. Supervisory agencies unable to enforce bank compliance with laws and regulations are consequently unable to ensure the safety and soundness of the banking sector and stability of the financial system. Without the abovementioned legal preconditions, the authority and credibility of bank regulatory and supervisory agencies are undermined.

A deposit insurance system should be established by statute, implemented through regulations, and transparent. There are a number of decisions that need to be made regarding the structure and management of the deposit insurance fund that also need to be incorporated into the legal infrastructure. The legal framework should explicitly:

- Name the system administrator;
- Provide for administration of the system;
- Specify whether participation in the deposit insurance system is mandatory or voluntary;
- Specify how the system will be funded (ex ante or ex post);
- Address the types of claims covered by the system; and
- Specify the extent of coverage provided.

As the U.S. banking system has developed, the government has had to reevaluate these considerations. For instance, at one time federal deposit insurance participation was voluntary in some U.S. states. However, these states' deposit insurance funds could not provide adequate coverage. Non-federal deposit insurance participation proved to pose a risk to the stability of the banking system by weakening consumer confidence. Therefore, a decision was made to make federal deposit insurance mandatory for all deposit-taking institutions.

VI. Deposit Insurance Structures

Deposit insurance schemes are divided into three categories: pay-box, pay-box with extended powers, and risk-minimizer. In a pay-box system, the deposit insurer is strictly responsible for receiving deposit insurance premiums and paying out insured deposits in the event of a bank failure. The deposit insurer would not possess bank licensing, supervision, resolution, or receivership responsibilities. Sixty percent of all deposit insurance schemes are pay-box systems.

In addition to paying out deposits, the pay-box with extended powers scheme also provides the deposit insurer with some bank resolution authority. While this system does not provide supervision, it often has access to risk assessment information regarding the banks to assess better the potential risks to the insurance fund. There

are approximately 24 national deposit insurance schemes that have adopted this approach.

The U.S., Canada, and the Philippines use the risk minimizer system. The system depends upon risk management assessment tools to play a more active role in identifying and monitoring risks in the financial system to mitigate the risks to the insurance fund. In order to be able to identify, assess and monitor the risks to the financial system on an on-going basis, risk-minimizer deposit insurance authorities are often granted the powers to license, regulate, and supervise banks, and may possess additional resolution and receivership powers.

VII. Regulatory Authority

The legal framework should grant the supervisory agency and deposit insurer the ability to issue regulations in order to react quickly to a situation rather than go through a lengthy legal process. U.S. regulations are developed through a multi-step process whereby the proposed rule making is made available to the public for a 30-to-90 day notice and comment period. The notice and comment period allows the banks to provide input into the process, encouraging an open and healthy dialogue between the banks and regulators. This unique process also allows the regulator to listen to the needs and concerns of the banking industry and public.

Summaries of the types of comments received are included in the preamble of the final rule, and the agency provides a response with regard to why or why not the comments were adopted into the final regulation. After the notice and comment period has closed, the agency compiles the feedback and drafts the final rule. The agency's board of directors is responsible for reviewing and voting on the final rule. Once approved, regulations are enforceable by law. **This transparent process helps to engender respect for and understanding of the regulations by the bankers and the public.**

VIII. U.S. Deposit Insurance Fundamentals

The goals of the U.S. deposit insurance fund are to protect depositors by insuring their deposits and **to resolve failed institutions.** A discussion on bank resolutions and receiverships is included in a later section.

IX. Deposit Insurance Funding

The U.S. insurance fund has two sources of funding, interest earnings from investments and deposit insurance assessments paid by participating banks. U.S. deposit insurance funds can only be invested in U.S. Treasury obligations to minimize the risk to the fund. Investing the insurance funds in the stock market is prohibited and inadvisable due to the fact that there is a strong correlation between the banking sector and financial markets; if there is a systemic problem in the banking sector, then it is also likely that the financial markets will be affected. The deposit insurance fund is the banking

system's safety net, and it is critical that the FDIC have readily available funds to pay out depositors in the event of a bank failure.

X. Deposit Insurance Application

Every new institution that wishes to become a chartered bank must apply to the FDIC for deposit insurance. A bank's deposit insurance application is evaluated based on seven statutory factors: financial history and condition, adequacy of capital structure, future earnings prospects, general character of management, risk to deposit insurance funds, convenience and needs of the community, and consistency with the powers in the Federal Deposit Insurance Act. The FDIC also requires separate applications to establish new branch offices, to engage in trust activities, or to merge with or acquire another institution.

XI. Deposit Insurance Reserve Requirement

The adequacy of the U.S. deposit insurance fund is measured by the deposit insurance reserve ratio. The reserve ratio is calculated by taking the total deposit insurance fund balance minus the expected losses, and then dividing it by the number of insured deposits. Coverage for the expected losses is set aside in the Contingent Loss Reserve (CLR). The CLR is determined by a financial risk committee and represents the probable and estimated losses from bank failures within the next twelve months.

The FDIC Board of Directors may set the Designated Reserve Ratio (DRR) between 1.15 percent and 1.50 percent, and the current DRR is 1.25 percent. The current reserve ratio for the U.S. is at 1.21 percent, slightly below this target rate. Depending on market conditions and the expected losses to the insurance fund, the Board of Directors can adjust the DRR as appropriate. In deciding the assessment rates, the FDIC Board has the flexibility to determine how quickly it wants the fund to meet the DRR. The ability to adjust the DRR and assessment rates allows the FDIC to react better to financial conditions and the needs of the banking system.

XII. Risk-Based Premium System

The U.S. deposit insurance funding scheme has recently undergone some restructuring. In 1991, the FDIC introduced a risk-based premium system that assesses high rates on those institutions that pose a greater risk to the insurance fund. The FDIC assigns each insured institution to one of nine risk categories based upon its capital group assignment and its composite CAMELS² supervisory rating.

Since the Savings and Loans crisis of the early 1990s, the insurance fund was almost exclusively funded from the interest earned from U.S. Treasury investments. Because the insurance fund was adequately capitalized, for ten years, over 95% of insured institutions paid nothing for deposit insurance. During this period, a number of new banks were chartered that were afforded deposit insurance without paying premiums.

² Capital, Asset Quality, Management, Earnings, Liquidity, Sensitivity to Market Risk (CAMELS).

This presented a moral hazard that allowed new financial institutions to take advantage of the deposit insurance coverage without ever having a true financial stake in the system, and the system was financed by those who had paid in the past. The recently enacted Deposit Insurance Reform Act addresses the inequalities in the system by reclassifying the risk assessment groups and ensuring that every risk group pays something into the insurance fund.

XIII. Deposit Insurance Coverage

The deposit insurance coverage limit in the U.S. is \$100,000 per individual account, \$200,000 for joint accounts, and \$250,000 for retirement accounts. If structured properly, it is possible for an individual to have over \$1 million in deposit insurance coverage at one institution. The \$100,000 limit assumes that those who have over \$100,000 have a certain level of financial sophistication and therefore would have multiple bank accounts at different institutions in order to ensure deposit insurance coverage for all of their money held in the banking system. Conversely, those with deposits under \$100,000 are considered to be less financially savvy and thus more likely to have all of their deposits held at one institution. As a result of the Deposit Insurance Reform Act, the FDIC now also has the ability to increase deposit insurance coverage based upon inflation.

XIV. Risk-based Supervision

The fundamental objectives of bank regulation and supervision are to ensure the safety and soundness of the banking sector and assist in maintaining the financial health of the overall economy. The independence of the central bank and supervisory agencies is essential for effective supervision. **The inability of bank supervisory agencies to conduct independent analyses and to take appropriate corrective actions when needed, because of political coercion or other governmental interference, undermines the credibility and effectiveness of such agencies.**

The FDIC examines banks to maintain public confidence, review compliance with laws and regulations, protect the deposit insurance fund, and develop an appropriate response to any problems identified. The central components of bank supervision in the U.S. include: on-site examination supported by off-site monitoring; a risk-focused supervisory approach as opposed to one that is strictly compliance-based; informal and formal enforcement actions; and intra- and interagency coordination.

XV. Effective Communication

Communication with the banks should not be limited to the on-site exams; supervisors need to be engaged in a continuous dialogue with the banks they oversee. To accomplish this, the FDIC assigns a Relationship Manager who is responsible for communicating with each bank in their portfolio on an ongoing basis. The lines of communication are reciprocal, and banks are encouraged to keep their Relationship

Manager informed of any changes in bank structure or business lines, such as the introduction of a new product or service, as well as to ask questions about new regulations or supervisory guidance.

XVI. Consumer Protection

In addition to bank supervision, the FDIC is mandated with protecting consumers from unfair and deceptive practices. Unfair practices cause or are likely to cause substantial injury that is not reasonably avoided by consumers and not outweighed by countervailing benefits to consumers or competition. Deception trade practices include representations, omissions, or practices that are likely to mislead consumers, who acting reasonably under the circumstances, and are likely to cause harm.

XVII. On-Site Supervision

The best way to assess the true financial condition of a bank is through an on-site examination. The on-site examination process places a strong emphasis on planning and risk identification. Prior to the exam, the examination team engages in the following activities:

- Meet with senior bank management;
- Review financial results since the prior exam;
- Assess changes in the risk profile of the bank;
- Evaluate economic and competitive influences;
- Establish priorities and assemble staff; and
- Communicate proposed examination strategy to field/regional office management.

All U.S. bank supervisory agencies use a Uniform Financial Institutions Rating System, otherwise known as CAMELS, to evaluate the financial institutions they oversee. For safety and soundness examinations, each financial institution is assigned a composite rating based on an evaluation and rating of six essential components of their financial condition and operations: the adequacy of capital, the quality of assets, the capability of management, the quality and level of earnings, the adequacy of liquidity, and the sensitivity to market risk. The composite rating is based on a scale of 1 to 5, with 1- and 2-rated banks considered healthy institutions and 3-, 4-, and 5-rated banks considered “troubled institutions,” which are more closely monitored.

The FDIC also conducts specialty exams that evaluate banks’ information systems, trust operations, compliance and consumer protection activities, and performance under the Community Reinvestment Act.

XVIII. Off-Site Monitoring

The off-site monitoring function falls under the responsibility of both the Division of Supervision and Consumer Protection and the Division of Insurance and Research.

Off-site monitoring enables the supervisory agency to assess a bank's financial condition between on-site examinations, providing an early warning of developing areas of concern or risk exposure. Banks are required to submit financial data on a quarterly basis using a standardized electronic form known as Call Reports. With the information collected from the Call Reports, the FDIC has developed several off-site surveillance models and red flags to monitor developing banking sector trends, including: Statistical CAMELS Off-Site Rating, Growth Monitoring System, Quarterly Lending Alert, Real Estate Stress Test, and a model that closely monitors newer institutions, which are known to have a significantly higher default probability.

XIX. Problem Banks and Enforcement Actions

If there is one lesson to learn from the U.S. experience, it is to act quickly and efficiently when dealing with problems at banks. The U.S. experience has further demonstrated that problems do not tend to resolve themselves without corrective measures. Problem banks pose a significant risk to the safety and soundness of the banking sector and the stability of the financial system. **Allowing a problem bank to continue without corrective measures simply increases the risk to the banking system and ultimately the liability of the government to cover losses.** Therefore, it is critical for bank supervisory agencies to have the legal authority to issue and enforce corrective actions and to remove problem banks from the banking system. Prompt action is required in order to maintain confidence in the financial system and prevent the problems from spreading to healthy banks and sectors of the economy.

The source of problem situations at banks is largely a result of weak or poor management. Poor management is apparent from an institution's:

- Lack of understanding of the potential risks related to a particular business activity;
- Lack of fundamental knowledge or awareness of standard operating practices or other requirements for critical business activities;
- Weak or ineffective risk management programs; and/or
- Pursuit of motives inconsistent with the institution's best interests.

Supervisory measures are primarily designed to address practices, conditions, or violations of law that could result in the risk of losses or damage to a financial institution. The supervisory response is generally correlated to the bank's CAMELS rating. Institutions with a composite CAMELS rating of 3, 4, or 5 are generally identified as problem institutions and subjected to enforcement actions. Enforcement actions can either be formal or informal depending on the severity of the problems and regardless of the CAMELS rating. Informal actions include:

- Board Resolutions; and/or
- Memorandum of Understanding (between the bank and FDIC).

While informal actions are kept confidential and are not enforceable in a court of law, non-compliance with informal enforcement actions often justifies the use of formal

enforcement actions. Therefore, the existence of informal actions strengthens the effectiveness of formal enforcement actions. Formal enforcement actions are made public and are legally enforceable. They include:

- Cease and Desist Order with regard to unsafe or unsound practices and violations;
- Affirmative Action to correct unsafe and unsound conditions or to attempt to prevent future violations and practices before the situation becomes more serious;
- Temporary Cease and Desist Order;
- Removal and Prohibition of an individual or institution-affiliated party from participation in the affairs of any insured financial institution;
- Civil Money Penalties levied against individuals, banks, institutions, and/or affiliated parties.
- Prompt Corrective Action (PCA) authorizing the FDIC to initiate supervisory actions for institutions that are not adequately or well-capitalized; and/or
- Insurance Termination, which effectively closes the bank.

Formal enforcement actions serve as a strong deterrent, especially when the institution's Board of Directors can be held personally accountable for problems in a bank.

Resolutions of problem situations often do not result in receivership. Corrective actions may be sufficient to return the institution to a safe and sound condition; the institution may be acquired by or merged into a stronger institution or company; or the institution may be self-liquidated with no impact to the deposit insurance fund. The role of bank management largely determines the success or failure of resolving problem situations. Good management is able to overcome challenges and ensure that the bank gets back on track. Ineffective management will not be able to correct a problem situation and will likely end up contributing to the failure of the bank.

Interagency communication and coordination are essential components of an effective supervision framework, especially as it pertains to problem institutions.

All of the U.S. federal regulators meet once a month to discuss problem banks. These regular meetings help to ensure that all regulatory institutions are aware of any problems in the banking system and that prompt corrective action can be put quickly into effect. Once a bank has failed, the agency that has granted the bank's charter (e.g. the OCC or state banking departments), revokes the charter, closes the bank, and the FDIC is appointed the receiver of the failed bank's assets and liabilities. Although the FDIC has backup supervisory authority for all insured institutions, it would rarely exercise this authority without coordinating its efforts with the chartering agency.

XX. Resolving Bank Failures: Resolutions and Receiverships

To maintain confidence and stability in the U.S. financial system, the FDIC will protect insured depositors in a bank resolution by:

- Minimizing the overall cost to the insurance fund, provided that systemic risk is avoided or mitigated; and
- Effectively managing the resolution and receivership process through:
 - Timely pre-failure supervision and closure;
 - Providing prompt access to insured deposits; and
 - Maximizing returns to creditors.

Once a bank fails, the FDIC is immediately appointed as receiver for insured institutions and conducts a cost test or systemic risk determination. As a result of the savings and loans crisis in the late 1980s and early 1990s, Congress enacted the Federal Deposit Insurance Corporation Improvement Act (FDICIA) in 1991 and introduced the Least Cost Transaction requirement. The Least Cost Transaction requirement states that when the FDIC is acting as the receiver, it must pursue actions that have the least cost to the insurance fund. The only instance where the FDIC is not bound by the Least Cost Transaction requirement is when there has been a systemic risk determination made by the Federal Reserve Chairman, Treasury Secretary, and the U.S. President.

The FDIC has special receivership powers that enable the agency to have control over all assets, contract rights, and privileges of the failed institution, including: selling all or parts of a failed institution to another insured institution; enforcing or repudiating contracts; voiding oral contracts or fraudulent transfers; allowing or disallowing creditor claims; and requesting a stay of legal proceedings for up to 90 days.

The grounds for closing a bank and appointing the FDIC as receiver include critical undercapitalization; assets insufficient to meet obligations; unsafe or unsound banking practices; willful violation of a Cease and Desist Order; accounting fraud or money laundering; and/or termination of deposit insurance.

PCA provides an institution 90 days to raise capital and address its problems. The FDIC Division of Resolutions and Receiverships takes advantage of this time period to prepare for a potential bank failure. During this time the FDIC carefully reviews the bank's assets and liabilities to determine the potential market value should the appropriate resolution action be to sell all or part of the institution.

If recapitalization is not effective, the FDIC will begin the marketing process. The FDIC approaches other strong institutions with its bid package and allows these institutions to review the insolvent bank's books directly. Institutions will then submit their bids as the FDIC waits for the chartering agency to close the bank.

The FDIC has four principal resolution transactions it can pursue:

- Purchase and Assumption, including:
 - Whole Bank
 - Optional Loan Pools
 - Loss Share

- Bridge Bank;
- Insured Deposit Transfer;
- Deposit Payoff; or
- Open Bank Assistance.

The FDIC manages its receivership role as a business and requires a great deal of strategic planning prior to and during the receivership process. Given that closing a bank requires quick and immediate action to maintain public confidence in the banking system, a typical bank closing occurs over a weekend. In most cases, insured depositors' accounts are transferred to a new financial institution. As a goodwill gesture, most acquiring institutions will also agree to assume uninsured depositors' accounts. If the deposits are not transferred and there is going to be a payoff, the FDIC will normally provide checks for insured deposit amounts by Monday morning. **The key to this process is to ensure the public that the government is going to honor its obligations and that depositors will have access to their money with little to no disruptions.**

During the receivership process, one of the first actions taken by the FDIC is usually to replace senior management with FDIC employees. Other bank personnel are retained to help with the operations of the receivership. During the receivership lifecycle, the FDIC undertakes the following activities:

- Strategic planning, including:
 - Post-closing strategic resolution plan,
 - Receivership status report and action plan, and
 - Quarterly updates of business plans;
- Performing customer service;
- Marketing;
- Operating under delegations of authority;
- Performing receivership accounting and financial/regulatory reporting;
- Paying dividends to the FDIC and other creditors;
- Managing litigation; and
- Terminating the receivership

When a bank is liquidated there is a priority of claims by which the FDIC, depositors, creditors, and shareholders receive payment. It is important to note that each stakeholder is paid out in exactly the order laid out below and only after the previous stakeholder has been fully compensated.

The Priority of Claims is as follows:

- Expenses of Receivership incurred by the FDIC;
- Insured Deposits paid immediately from the insurance fund and reimbursed by the sale of the bank's assets;
- Creditors;
- Unsecured Debt Holders; and

- Shareholders, who are rarely compensated unless the bank failure was due to liquidity problems.

XXI. Independence of the Regulatory and Supervisory Agencies

In many countries, the independence and integrity of bank regulatory and supervisory agencies are compromised by political pressures. There have been several instances in the U.S. where the president of a bank contacted senior management at the supervisory agency in an attempt to influence or even change decisions made by the bank supervisory staff. In response to similar situations, the U.S. has developed the following approaches:

- **PCAs** clearly outlined in the law and therefore not dependent on supervisory judgment;
- **Corporate Governance** by vetting the findings and recommendations of an on-site examination through several layers of management prior to their presentation to the bank; and
- **FDIC Employee Personal Indemnity** so long as they are in compliance with the law and acting within their jurisdiction.

XXII. Next Steps

FSVC has the expertise to provide assistance to strengthen supervisory and deposit insurance functions in Ecuador. If requested, FSVC volunteers and staff could also work with CARANA and USAID to identify the technical assistance needs of Ecuadorian bank supervisory and deposit insurance institutions and potential activities to address these needs going forward.

XXIII. Attachments

The following PowerPoint presentations are included as attachments to this report:

1. Bank Failure, Resolution and Liquidation
2. Legal System Considerations Regarding the Conditions for an Effective Deposit Insurance System
3. FDIC Brief Overview
4. Deposit Insurance and Bank Insolvency
5. The Deposit Insurance Fund
6. Risk-Based Supervision